# Review of GO plc's application for funding of the net cost claimed to have been incurred to provide universal service obligations during 2010

*Proposed Decision*

Consultation Document

MCA/C/14-1858

Publication Date:

17TH APRIL 2014

Closing Date for submission of responses:

30TH MAY 2014– AT 12.00PM CET

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# EXECUTIVE SUMMARY

In accordance with national law, the designated universal service provider (hereafter ''USP'') has the right to submit a written request to the Malta Communications Authority (hereafter the ''MCA" or the ''Authority'') of any unfair burden which the USP concerned believes it incurred to provide part or all of the universal services in line with its obligations. Universal services are defined as a minimum set of services of specified quality which are to be made available to all end-users regardless of their geographical location and, in the light of specific national conditions, at an affordable price[1]. GO plc (hereafter ''GO'') is the designated undertaking responsible to provide access at a fixed location, directory enquiry services and directories, public payphones, specific measures for disabled users, reduced tariff options and control of expenditure. For the first time, in 2012 GO submitted its funding application for the unfair burden it claims it had suffered in providing universal services during the financial year 2010[2].

GO requested a claim for USO funding in respect of the following components of the universal service obligations (hereafter ''USO''); Geographical Component; Public Payphones; Social Tariffs and Directory Enquiry Services. As part of GO's USO funding application, intangible benefits were also included in order to calculate the net cost of the USOs.

The Authority initiated a tender process to select a contractor and commissioned Ernst & Young (hereafter the ''EY'') to carry out an assignment split in two phases:

- a Reasonability Phase to evaluate the reasoning behind GO's claim; and
- a Calculation Accuracy Phase to audit and verify the various calculations, including those used to quantify the intangible benefits.

Following the verifications and audit carried out by EY, it emerged that GO have suffered an unfair burden for providing the elements of the specified universal services. The results of the cost calculation and the conclusions of the audit on each USO component are being published and are found in Section 4 and Annex 1 below.

[1] Electronic Communications (Regulation) Act (Cap. 399 of the Laws of Malta), article 2 thereof

[2] GO's financial year was from 1st January to 31st December 2010

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# 1. INTRODUCTION

The Electronic Communications (Regulation) Act (Cap. 399), specifies that the Authority is the entity responsible to ensure that all users have access to universal services. Universal Services are a minimum set of services of specified quality which are made available to all users irrespective of their geographical location, in the light of specific national conditions and at an affordable price.

In April 2010, the Authority published a decision entitled *'Universal Service Obligations on Electronic Communication Services'*[3] (hereafter *''USO Decision 2010''*) which established a number of universal services to be provided by an entity in part or in full as the designated undertaking. Unlike as in the previous USO decision (published in 2003), which was based on the previous USO framework, the Authority could now designate different undertakings, or a number of undertakings to provide different elements of the universal services. The USO Decision 2010 established that in default of an expression of interest from third parties to provide a universal service, or if the set criteria failed to be satisfied, the Authority designated GO to provide the universal service/s in question. To this effect, GO was designated to provide the following universal services:

- Provision of access at fixed location;
- Directory enquiry services and directories;
- Public Payphones;
- Specific measures for disabled users;
- Provision of reduced tariff options; and
- Ensuring users can control expenditure.

As outlined in the Electronic Communications Networks and Services (General) Regulations, SL 399.28 (hereafter the "Regulations"), an undertaking designated to provide universal services has the right to apply to receive funding for any net costs accrued in meeting these obligations[4]. For the first time ever, in January 2012, GO submitted an application for the USO funding for an unfair burden it claimed to have incurred during the financial year 2010. To this effect, following a tendering process the Authority commissioned EY as its consultants to evaluate the reasoning behind GO's claim and to audit and verify the various calculations.

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[3] Updated in September 2011

[4] SL399.28, Regulation 30 (1)

# 2. BACKGROUND

In accordance with the USO Decision 2010, any undertaking designated for the provision of all or parts of the universal services may submit in writing an application for USO funding within a time period of nine months following the end of the previous financial year. Following a number of requests from GO, taking into consideration that such claim was the first of its kind the Authority granted a number of extensions to the established timeframe to enable GO to be in a better position to submit a claim with all the necessary details.

In January 2012, GO submitted an application for USO funding for the net costs it claimed to have incurred in providing universal services during 2010. In March 2012, GO submitted its final, more detailed, documentation as requested by the Authority to support its claim.

In July 2012, the Authority decided to commission an expert consultant in order to evaluate the reasoning behind GO's claim and to audit and verify the various calculations. To this effect a tender document entitled *"Review of GO's application for funding of the net cost claimed to have been incurred to provide universal service obligations during 2010"* was issued on the lines of public procurement regulations. Following an adjudication process which commenced in September 2012, EY were chosen to provide this service and was formally commissioned in December 2012.

As part of the evaluation exercise, the tender established two main specific objectives, namely a Reasoning Phase and a Calculation Accuracy Phase which are described below.

## 2.1 REASONING PHASE

The goal of the Reasoning Phase was to analyse the validity of the reasoning GO used to support its claim. As part of this process, EY were required to thoroughly investigate and assesses the following elements on each universal service:

- the grounds on which the claim for funding are based;
- whether the claim is coherent with regulatory principles;
- the extent to which the claimed funding is attributed to universal service obligations; and
- the approach used to quantify the intangible benefit aspect of the claim.

EY finalised the Reasoning Phase in July 2013 for the MCA, and its findings were sent to GO. The findings emanating from this Phase can be found under the section 'Assessment' below.

## 2.2 CALCULATION ACCURACY PHASE

Specific universal services which were assessed as valid in the Reasoning Phase were analysed in the Calculation Accuracy Phase. The objective of this phase was to audit and verify the various calculations, including those used to quantify the intangible benefits that GO provided in its claim. EY finalised the Calculation Accuracy Phase in February 2014.

The MCA requested EY to prepare a public version of the review report which is sufficient for the purpose of making the results of the cost calculation and conclusions of the audit publicly available while protecting financial information of a commercially sensitive nature. This report is being made available in Annex 1 of this document. The summary of the findings that result from this Report can also be found under the section 'Assessment' found below in this document.

# 3. LEGAL BASIS

The fundamental aspects of costing and financing of the universal services are outlined in the Regulations and in the Directive 2002/22/EC of the European Parliament and of the Council (hereafter the ''USO Directive'').

Regulation 30 of the Regulations stipulates that a universal service provider designated to provide all or parts of the universal service obligations outlined under regulations 21 to 28, may submit a written request to the Authority to fund the net costs it claims to have incurred in providing the universal service/s concerned. Such a request must be accompanied with detailed and supporting information to enable the Authority to determine whether the claim represents an unfair burden to the USP[5].

The Authority or an appointed independent body shall determine if the USO funding application submitted by the designated undertaking represents an unfair burden on that undertaking. The Regulations stipulate that an audit exercise shall verify the calculations of any net costs claimed on the basis of any market benefit which accrues to the designated undertaking and that the universal service obligations were provided in a cost effective manner[6]. If it is determined that the claimed components do not represent an unfair burden, the Authority shall inform the designated undertaking giving its reasons. Following the auditing exercise the results shall be made publicly available.

The financing of universal service obligations is subject that the Authority or an appointed independent body finds that an undertaking has suffered an unfair burden. Regulation 31 of the Regulations stipulates that the Authority shall compensate the designated undertaking from public funds with the approval of the Minister responsible for finance and, or from sharing the net cost between the providers of the electronic communications networks and services. The identification of the source of the USO funding, which could depend on the nature of the universal service in question, shall be treated by the MCA in a separate consultation.

[5] SL399.28, Regulation 30 (1), (2)

[6] SL399.28 Regulation 30 (4), (7)

# 4. ASSESSMENT AND AUDIT OF NET COST

As mentioned earlier, the Authority commissioned EY to evaluate the reasoning behind GO's claim and to audit and verify the various calculations of the net cost GO claimed it had suffered during 2010 in fulfilling its obligations as the undertaking designated to provide universal service obligations. The specific objectives of the evaluation exercise consisted of two main outputs, namely the Reasoning Phase and Calculation Accuracy Phase. EY has compiled its findings which are being captured in the sections below. The MCA requested EY to prepare an abridged report which is sufficient for the purpose of making the results of the cost calculation and conclusions of the audit publicly available while protecting financial information of a commercially sensitive nature. This public version of EY's *"Review of GO plc's application for funding of the net cost claimed to have been incurred to provide universal service obligations during 2010"* is available in Annex 1 of this document.

For the financial year 2010, GO has claimed for the following USO components:

- Geographical Component;
- Payphones;
- Social Tariffs;
- Directory Enquiry Services; and
- Intangible Benefits.

GO has included two different scenarios in their claim for the net costs, namely "Current net cost" which is based on actual line rental charged to their subscribers, and a second scenario entitled "Current cost after rebalancing" based on higher line rental tariffs to cover their claimed line rental cost and return on capital.

The table below shows the original claim made by GO:

| USO Components | Scenario 1<br>Current Net Cost | Scenario 2<br>Current Cost After Rebalancing |
|---|---|---|
| Geographic component | (1,129,206) | (21,724) |
| Payphones | (281,157) | (281,157) |
| Social tariffs | (398,653) | (690,314) |
| Directory enquiry service | (79,646) | (79,646) |
| Intangible benefits | 197,200 | 197,884 |
| **Total** | **(1,691,462)** | **(874,957)** |

GO's claim was modelled on a top-down model based on their operational data using a historical cost accounting methodology, taking a fully allocated cost approach. As part of their analysis, during the Reasonability Phase and the Calculation Accuracy Phase, EY prepared an information request list to collect additional detail from GO.

In its USO claim GO included access deficit as part of their submission. Access deficit can be described as a situation in which GO's overall revenues emanating from connection services and line rental, fail to cover actual overall costs pertaining to the access line. This concept is distinct from the net cost of a universal service obligation, and on the basis of the Sixth Schedule of the Regulations, such a cost should be calculated as the difference between the net cost a designated undertaking would incur if it had to operate with the universal service obligations, this in contrast to if it had to operate without such universal service obligations. In the Reasonability Phase EY concluded that Access deficit should not form part of the total USO claim. However in GO's claim, the Access Deficit element is also being captured in the geographical component and social tariffs in Scenario 1 Current Net Cost (see table above). This was analysed further in the Calculation Accuracy Phase.

## 4.1 GEOGRAPHICAL COMPONENT

In its claim for providing access to telephony services at a fixed location, GO based its calculations on the basis of individual Main Distribution Frames (hereafter ''MDFs'') to determine unprofitable areas. From a total of twenty two MDFs, there were three identified unprofitable areas. EY's Reasoning Phase established that this was an acceptable approach and was also being used in other Member States. Besides the different variables using the current net-cost and rebalancing scenarios as stated earlier, GO also included different scenarios including and excluding on-net traffic.

In the Reasoning Phase EY also established that based on international practice and on the provisions of the USO Directive, the geographic component could form part of the USO claim and therefore it could be based on the "Current cost after rebalancing" scenario. EY also noted that in their 2010 claim, GO stated that because of competition it was too late to rebalance the line rental fee.

Further clarifications on whether to include on-net traffic or not were required to be provided by GO during the Calculation Accuracy Phase, and to this effect discussions were held between EY and GO to gather intelligence on on-net traffic margins and the loss derived from on-net calls in bundles. Taking into consideration that there was no price control action by the Authority in this regard, EY concluded that on-net performance was derived from pricing decisions taken by GO rather than from regulatory measures imposed by the Authority. Therefore, the USO claim should not be affected by decisions derived from competitive pressures. More information on this USO component is available in Annex 1 of this document.

It was therefore concluded that the Geographical component should be based on the scenario of the Current net cost after rebalancing excluding on-net traffic which amounts to a net cost of €14,010.

## 4.2 PAYPHONES

In GO's application, public payphones were based on the total number of payphones installed around Malta and Gozo, amounting to total of 939 out of which 734 were according to GO unprofitable payphones. In the USO decision 2010, the Authority established a minimum set of parameters of payphones required in each locality, depending on the population figures. If GO based their claim on the mentioned parameters, the unprofitable number of payphones would have decreased to a net margin of 105 instead of the claimed 734.

In the Reasonability Phase, EY reported that on the basis of the USO Directive and international practice, payphones could form part of the USO claim. GO provided revenues and costs information to arrive at the net cost of each unprofitable payphone. Certain cost allocation methods used in quantifying the losses on every claimed unprofitable payphone was required to be revisited in greater detail in the Calculation Accuracy Phase. The main issue of this component was related to the quantum of public payphones, more specifically whether to include the optimal number of payphones being provided in accordance with the minimum requirements established in the USO Decision 2010, or whether to base the claim on the current existing number of payphones. Amongst other things, EY has taken into consideration that although prior to 2010 there was no official mechanism in place for the removal of public payphones, the Authority had approved a request from GO to remove a number of payphones in 2009[7].

Following the review of work in the Calculation Accuracy phase, the Authority proposes that the payphone claim should be based on the optimal number of payphones in accordance with the USO Decision 2010. The net cost of public payphones amounts to €26,276. More information on this USO component is available in Annex 1 of this document.

## 4.3 SOCIAL TARIFFS

GO also claimed for the provision of social tariffs to render the universal service affordable to eligible end-users. This component includes Telecare services and free line rental to low income earners, or to people with special social needs included in a list specifically provided by the responsible Ministry or Government department.

For this claim, GO submitted two scenarios; one based on the current net cost with a total of €398,653 and another scenario based on cost after rebalancing with a total of €690,314. During the Reasonability Phase, EY concluded that based on the USO Directive and on international practice, social tariffs could form part of the USO claim since it is a social obligation imposed on GO by the Authority. The numbers of social beneficiaries claimed were confirmed with the responsible Ministry and a minor difference was noted between the number claimed by GO and that published on the Ministry website. Following the Calculation Accuracy Phase, EY concluded that the claim should be based on scenario one to exclude access deficit from the claimed amount. If access deficit had to be included in the USO claim, the Government/entities providing the source of funding for this

[7] A few payphones were granted subject to certain conditions being met

component would be financing a higher line rental rate than that actually paid by the regular end-users. More information on this USO component is available in Annex 1 of this document.

The social tariff claim should be based on the current net cost scenario and it amounts to a net cost of €372,877.

## 4.4 DIRECTORY ENQUIRY SERVICES

As part of their claim GO included the net cost for the provision of the directory enquiry services which as per the USO decision 2010 had to be made available to all end-users at an affordable rate. Currently, there is an agreement in place between GO as the designated undertaking, and the local telephone operators in order for GO to gain access to other operators' databases and to be in a position to provide a comprehensive telephone directory enquiry service to all end-users. Following the Reasonability Phase, EY concluded that directory enquiry services can form part of the USO claim, but further assessment was required to be carried out in the Calculation Accuracy Phase. EY have considered the arithmetical accuracy and allocation of costs and revenues, and reported that there were no exceptions.

To this effect, EY concluded that the claim should remain as it was originally submitted by GO namely that of €79,646. More information on this USO component is available in Annex 1 of this document.

## 4.5 INTANGIBLE BENEFITS

In accordance with article 30(4) of the Regulations, the Authority or a third party shall also assess and calculate any intangible benefits accrued by the designated undertaking for providing universal services. In their claim, GO included information on the ubiquity benefit which arises when end-users move from uneconomic areas to economic areas and the brand enhancement benefit which can be defined as the enhancement of the USP brand by offering universal services and its influence on end-users' perception which might impact the overall profitability.

Following the Reasonability Phase, EY concluded that the approach adopted by GO to compute the intangible benefits was required to be scrutinised in more detail during the Calculation Accuracy Phase in order to assess whether alternative estimation methods could have been used to quantify ubiquity and brand enhancement, and to identify the reasons why life cycle and marketing benefits were left out from the claim.

In the Calculation Accuracy Phase, EY reviewed the work and the calculations submitted by GO for the ubiquity benefit, and the calculations were adjusted to reflect the scenario adopted for the geographical component, based on rebalanced tariffs, including business customers and excluding on-net calls. Following EY's calculation review and adjustments, the ubiquity element has been revised from €6,505 to €10,731. More information on this USO component is available in Annex 1 in this document.

As regards to brand enhancement, GO based their calculation for this element on a percentage of advertising on different media such as TV, internet, mobile and fixed telephony. Following EY's review of work, the brand enhancement amount stated by GO in their claim remained unchanged at €190,695. More information on this USO component is available in Annex 1 in this document.

During the Calculation Accuracy Phase, EY have queried why life cycle and marketing benefits were excluded in GO's USO claim. Further information on this is also available in Annex 1 of this document.

Estimating intangible benefits is a challenging exercise by nature and different methodologies are generally used to assess them, nevertheless EY reported that the approach used by GO is reasonable and in line with international practice.

The value of the intangible benefits amounting to €201,426 would be deducted from the other USO components.

## 4.6 SUMMARY

The table below shows a summary of the calculated cost and audited result for each element of the USO:

| USO Components | Audited net cost |
|---|---|
| Geographic component | (14,010) |
| Payphones | (26,276) |
| Social tariffs | (372,877) |
| Directory enquiry service | (79,646) |
| Intangible benefits: | |
| - Ubiquity | 10,731 |
| - Brand Enhancement | 190,695 |
| **Total** | **(291,382)** |

# 5. SOURCE OF FUNDING

In the assessment process undertaken by EY it was established that GO, as the universal service provider has suffered an unfair burden for the provision of the geographical component, public payphones, social tariffs including Telecare and free line rental and directory enquiry services during 2010.

In accordance with regulation 31(1) of the Regulations, when the Authority establishes that a designated undertaking had suffered an unfair burden to provide a universal service, it shall be compensated by one or a combination of the following:

- from public funds with the approval of the government; and/ or
- by means of a sharing mechanism between providers of electronic communications networks and services[8].

More detail on the allocation of the source of funding on GO's claim for the financial year 2010 would be dealt with by means of a separate consultation document earmarked for publishing following the publication of this decision.

[8] SL399.28, Regulation 31 (1)

# 6. SUBMISSION OF RESPONSES

In accordance with its obligations under article 4A of the Malta Communications Authority Act [Cap. 418 of the Laws of Malta], the Authority welcomes written comments and representations from interested parties and stakeholders during the national consultation period which shall run from the 17/04/2014 to the 30/05/2014.

The Authority appreciates that respondents may provide confidential information in their feedback to this consultation document. This information is to be included in a separate annex and should be clearly marked as confidential. Respondents are also requested to state the reasons why the information should be treated as confidential.

For the sake of openness and transparency, the MCA will publish a list of all respondents to this consultation on its website, up to three days following the deadline for responses. The Authority will take the necessary steps to protect the confidentiality of all such material as soon as it is received at the MCA offices in accordance with the MCA's confidentiality guidelines and procedures[9]. Respondents are however encouraged to avoid confidential markings wherever possible.

All responses should be submitted to the Authority, in writing by no later than 12:00 on 30/05/2014 and be addressed to:

Ian Agius
Chief of Operations
Malta Communications Authority
Valletta Waterfront, Pinto Wharf,
Floriana, FRN1913
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Extensions to the consultation deadline will only be permitted in exceptional circumstances and where the Authority deems fit. The MCA reserves the right to grant or refuse any such request at its discretion. Requests for extensions are to be made in writing within the first ten (10) working days of the consultation period.

[9] http://www.mca.org.mt/sites/default/files/articles/confidentialityguidelinesFINAL_0.pdf

# Malta Communications Authority

## Review of GO plc's application for funding of the net cost claimed to have been incurred to provide universal service obligations during 2010

Abridged Version of Full Report

21 March 2014

Building a better working world

# Disclaimer notice

This report ("Report") was prepared by Ernst & Young Ltd. ("EY") for the Malta Communications Authority ("MCA"), under the MCA's instructions. This report is an abridged version of the full report addressed to the MCA which was prepared for MCA's internal use only and is not suitable to be relied on by any other party or for any other purpose.

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EY reserves all rights in the Report.

# Contents

# Introduction and background information

# Introduction (1)

The Malta Communications Authority ("MCA"), as the National Regulatory Authority ("NRA") of the electronic communications sector in Malta, is responsible for the regulation of a minimum set of electronic communication services essential for the general public to participate in society, and those which are already available to the great majority of citizens. These universal services should be available at just, reasonable and affordable rates ensuring persons on low income, those residing in geographically distant areas, persons with disabilities, and other vulnerable groups, have access to these services at reasonable prices.

Based on an MCA Decision in July 2003, updated by the Universal Service Obligations on Electronic Communication Services" decision (April 2010, updated September 2011; hereafter referred to as the "MCA USO Decision"), GO plc ("GO") was designated as the Universal Services Provider ("USP") for a number of Universal Service Obligations ("USO"), including:

- the provision of access at a fixed location,
- directory enquiry services and directories,
- public payphones,
- specific measures for disabled users,
- reduced tariff options, and
- measures ensuring users can control expenditure.

As per the provisions of EC Directive 2002/22/EC ("EC USO Directive") and the Electronic Communications Networks and Services (General) Regulations (July 2011; hereafter referred to as "SL 399.28"), in January 2012 GO submitted a request for funding of the net cost claimed to have been incurred to provide USO for the year 2010. Following a procurement process the MCA handed over the documentation to EY in December 2012.

# Introduction (2)

The MCA USO Decision delineates the key guiding principles and criteria for the evaluation of USO claim, the list of USO undertakings, the financing options and the designation processes. As per the EC USO Directive, article 12, and as per SL 399.28, regulation 30, the MCA or a body independent of the relevant parties appointed by the MCA shall verify the accounts and/ or other information serving as the basis for the calculation of the net cost of USO provided by the operator, with the results of the cost calculation and the conclusions of the audit made publicly available.

In the above context this assignment was aimed at assisting the MCA in assessing the funding application of the net cost claimed to have been incurred to provide USO during the year 2010 submitted by GO, and whether the evidence provided is sufficient and detailed enough to support this claim.

**Report organization**

This section ***"Introduction and background information"*** provides the background information to the claim and this report, including the scope of this engagement and the salient conclusions of the Reasoning Phase of the engagement.

The next section, ***"GO's approach and methodology"***, provides an overview of GO's claim, including GO's approach and methodology adopted.

The section ***"Analysis by USO component"*** delves into the analysis for the geographical component, payphones, social tariffs, and directory enquiry services. Intangible benefits are also considered before arriving at the summary of the conclusions related to the Calculation Phase of this engagement in the section ***"Calculation Phase: summary of conclusions"***.

# Scope

**Scope of our work**

In accordance with the contract terms, Ernst & Young Ltd. ("EY") has been requested by the MCA to assist in the review of GO's USO claim for the year ended 31 December 2010.

The assignment is split into two phases:

- ***Reasoning Phase***: assessment of the grounds on which the claim is based, whether it is coherent with regulatory principles, , the extent to which the claimed funding can be attributed to USO, and the approach used to quantify the Intangible Benefit.
- ***Calculation Accuracy Phase***: verify and audit the various calculations GO provided in their submissions

The Reasoning Phase included an initial assessment and a final assessment (following discussion with GO during which GO was given the opportunity to provide their feedback on the initial assessment) that was concluded in July 2013. The Calculation Accuracy Phase follows on the conclusions of the Reasoning Phase. An overview of the conclusions of the Reasoning Phase are provided on pgs. 9-11 of this report.

**Use of report**

This report provides an overview of the Reasoning Phase and details of the Calculation Accuracy Phase of the review of GO's application for funding of the net cost claimed to have been incurred to provide USO during 2010. This report is an abridged version of the full report addressed to the MCA. This abridged report forms part of a public communication process to be undertaken by the MCA with stakeholders, including a public consultation document which is scheduled to be issued following the completion of both the Reasoning Phase and the Calculation Accuracy Phase. The public consultation document shall provide stakeholders with the opportunity to comment on the conclusions of the Reasoning and Calculation Phases.

# Overview of GO's claim

- In line with the provisions of Article 12 of the EC USO Directive and Article 30 of the SL 399.28 on the financing of USO net costs where the designated provider is deemed to have suffered an unfair burden as a result of providing all or part of the universal service, GO has submitted a written request to receive funding for the net costs of meeting the USO for the year 2010. The claim was prepared by GO in conjunction with Marpij. This section presents an overview of this claim.
- GO's claim considers two scenarios.
  - ***Scenario 1*** - Current net cost: this is based on line rental rates as at 30 June 2010;
  - ***Scenario 2*** - Current cost after rebalancing: this is based on tariffs under a rebalancing scenario that is a hypothetical scenario under which GO's line rental tariffs are fully rebalanced to reflect the line cost.

| (in €) | Scenario 1 Current Net cost | Scenario 2 Current cost after rebalancing |
|---|---|---|
| Geographical component | -1,129,206 | -21,724 |
| Payphones | -281,157 | -281,157 |
| Social tariffs | -398,653 | -690,314 |
| Directory enquiry services | -79,646 | -79,646 |
| Intangible benefits | 197,200 | 197,884 |
| Total | -1,691,462 | -874,957 |

- In its covering letter dated 20 February 2012, GO explains that the rebalancing scenario is also presented in the claim dated January 2012 since this rebalancing figure "provides more transparent information for the MCA and also keeps open the option [for the MCA] to choose which model it wants to adopt in deciding." According to GO, "although [GO] is making a claim based on current tariffs, [GO] has provided the MCA with visibility to choose which model it wants to adopt without having to make prior complex calculations or assumptions."

# Reasoning Phase: Conclusions (1)

This section presents the salient conclusions of the Reasoning Phase, which dealt with:

- the grounds on which the claims for funding are based;
- whether the claim/s is coherent with regulatory principles;
- the extent to which the claimed funding can be attributed to USO; and
- the approach used to quantify the intangible benefit aspect.

The conclusions from the Reasoning Phase for each component of the claim were as follows:

| Component | Initial reasonability assessment |
|---|---|
| Geographical component | • This component relates to the provision of access at a fixed location to unprofitable areas.<br>• Based on international practice and the provisions of the EC USO Directive, the geographical component can form part of the USO claim.<br>• In view of the 1996 EC Communication which indicates that access deficit should not form part of the USO claim, the claim for the geographical component should be based on Scenario 2 – i.e. current cost after rebalancing scenario.<br>• The use of MDF as a basis to determine the unprofitable areas is an acceptable approach, and is being used in other countries.<br>• Prior to choosing whether to include or exclude “on net” traffic further clarifications are required and consequently whether it should be included in the geographical component calculation |

# Reasoning Phase: Conclusions (2)

<table>
<tr><th>Component</th><th>Initial reasonability assessment</th></tr>
<tr><td>Public payphones</td><td>
<ul>
<li>This component relates to the net cost of servicing the territory with public payphones.</li>
<li>On the basis of the EC USO Directive and international practice, payphones can form part of the USO claim.</li>
<li>Issue relates to the quantum of payphones on which the claim should be based, and whether:
<ul>
<li>the claim should be based on overall results or it should take into account only the unprofitable payphones; and</li>
<li>whether the claim should be based on the optimal number of payphones rather than the existing number of payphones taking into account the 2010 Decision Notice issued by the MCA on removal of payphones.</li>
</ul></li>
<li>The MCA is of the opinion that the claim should be based on the optimal number of payphones rather than the existing number of payphones.</li>
</ul>
</td></tr>
<tr><td>Social tariffs</td><td>
<ul>
<li>Under its current USO, GO is required to provide social tariff options to a number of users. GO provides two types of social services free of charge:
<ul>
<li>Line rental</li>
<li>Telecare service</li>
</ul></li>
<li>Based on the EC USO Directive social tariffs can form part of the USO claim, given that they represent a social obligation imposed on GO by the regulator.</li>
<li>Given that the assessment indicates that access deficit should not form part of the USO claim (unless this has resulted due to affordability issues imposed by the regulator) then it follows that the social tariff computation should be based on the current tariffs, i.e. Scenario 1 of GO's calculation.</li>
</ul>
</td></tr>
</table>

# Reasoning Phase: Conclusions (3)

| Component | Initial reasonability assessment |
|---|---|
| Directory enquiry services (DES) | • This component relates to the net cost of providing directory enquiry services<br>• Prima facie it would appear that DES can form part of the USO claim.<br>• Justifications need to be sought for the losses being claimed, and whether the costs being included represent unavoidable net costs incurred by an efficient operator.<br>• Furthermore, due consideration needs to be made to the fact that despite the fact that GO are claiming that DES are offered at a loss, no requests have been made since 2010 for an increase in the tariffs charged. |
| Intangible benefits | • The net USO cost is calculated after deducting intangible benefits that the operator derives from the provision of universal services<br>• Intangible benefits should form part of the USO computation. Though inherently difficult to quantify, international research shows that a number of claims in other countries have also included intangible benefits, with the main benefits relating to ubiquity, brand enhancement and marketing.<br>• In their USO application for funding, GO claim to have insufficient data to estimate the lifecycle benefit, and they claim that the marketing benefit is irrelevant because pay phones are not commonly used by consumers.<br>• Going forward, the approach GO has adopted to compute the intangibles benefits needs to be scrutinized in more detail in the Calculation Phase to assess the methodology adopted and computation undertaken in quantifying ubiquity and brand enhancement. |

# Reasoning Phase: Conclusions (4)

Having completed the Reasoning Phase which sought to address the methodological issues (i.e. grounds on which the claim is based, whether it is coherent with regulatory principles, and the extent to which the claimed funding can be attributed to USO), the next step was to consider the calculation actually undertaken and verify the various calculations GO provided in their submissions. An overview of GO's approach and methodology, as well as the salient conclusions of the Calculation Phase are presented on the next pages.

# GO’s approach and methodology

# GO’s approach and methodology (1)

GO has submitted a written request to receive funding for the net costs of meeting the USO for the year 2010. The claim was prepared by GO in conjunction with Marpij. As part of their submission, GO provided a model and a report on the methodology which set out the basis for their calculation of the USO funding requirement. An overview of their approach and key assumptions is provided in the following pages.

**Cost accounting basis**

- The claim is based on historic cost accounting (HCA), taking a fully allocated cost (FAC) approach.

**Approach and data sources**

- To arrive at the different USO cost components Go have adopted a top-down modelling approach based on GO operational data. Specifically, the following sources have been used:
  - Accounting data: GO’s management accounts and GO’s regulatory accounts
  - Technical data: GO’s Technical Department reporting
  - Revenues and traffic: Data warehouse IT
- The use of various data sources, though inevitable given the nature of the exercise, leads to the need to reconcile revenues and costs included in the USO claim to the audited regulatory accounts and statutory financial statements. GO have provided a reconciliation of revenues and costs included in the USO claim with the audited regulatory accounts.

# GO's approach and methodology (2)

**Data approximation**

- The claim was for 2010 and hence used historic 2010 data. However, in a number of areas where data was not available, assumptions and approximation were made by GO. As described in GO's claim, this is mainly related to:
  - "The revenue / traffic database presents all 2010 usage for active telephony services plus the monthly nominal rent of the line as per tariffs active on 30 June 2010. For a number of services which were inactive on this date, data warehouse IT identified the earliest service active between 30 Mar and 31 Dec."
  - "Technical data (tel. number/ active lines/ local loop length/ max broadband speed) are those of October 2011"
- In the September 2013 reply, GO explained that since customers can change their tariff plan at any time during the year, theoretically GO should have based their computation on monthly data (in terms of number of subscribers and tariff plans). For practical and simplification reasons, however, GO opted for the mid-year (i.e. 30 June referred to above) as an approximation for 2010. This resulted in differences compared to the regulatory accounts. GO have provided revenue and cost reconciliations between the USO figures and the regulatory figures, explaining the reasons for these differences.

# GO's approach and methodology (3)

**Efficiency factor**

- An efficiency factor relates to the telecom operator's input vs output ratio.
- When asked whether an efficiency factor has been included in the USO calculations, GO replied that "GO has to be considered as by nature an efficient operator, especially in the context of fierce competition and due to the fact that fixed tariffs are not rebalanced. GO cannot afford inefficiencies which jeopardise its market presence." Consequently, no efficiency factor has been included in the USO calculations.
  - Had an efficiency factor been included, this could have possibly resulted in a lower cost and a lower claim particularly in the geographical component, directory enquiry and payphones components. This however needs to be considered in the context of the size of the claim of these components.
  - Furthermore, as noted earlier certain revenues and costs are estimated on the basis of traffic volumes. In particular interconnection costs are estimated on the basis of traffic volume data and the termination rates as set by the MCA in its decision notice of 2009 and 2010. In its decision notice the MCA specifically notes that the termination rate "shall also be considered as the cost-oriented rates stemming from an efficient operator basis until the new LRIC Model comes into play". Therefore, an efficiency factor is already incorporated in part of the costs included in the geographical component.

**Return on Capital Employed (ROCE)**

- In the geographical component, public payphones and DES, GO is including a ROCE related to the capital used to provide the services. The ROCE is based on the MCA's Decision on the Weighted Average Cost of Capital ("WACC") of 12.56% for regulatory accounting periods ending on or after 31 December 2010 (MCA/D/11-0295, ECS WACC Review - 2011, pg. 6).

# GO’s approach and methodology (4)

**Fibre Based Lines**

- For the geographical component, net costs are based on revenues and costs of residential and business consumers using copper line. According to the MCA’s decision notice dated March 2002, “a connection to the public fixed telephone network must be capable of allowing users to make and receive national and international calls, enabling voice, facsimile and data communications. Such a connection must be capable of transmitting data via modems at a speed sufficient to permit Internet access.” The decision does not specify the type of technology to be used to provide access, and in practice copper lines are being used to provide the minimum required services including access. GO has deployed some fibre based lines, however these are normally provided to business customers which require additional services and increased speeds. Accordingly, the costs and revenues of fibre lines are not included in GO’s claim as they are considered to be outside the scope of USO.

**Limitations highlighted by GO**

- GO highlight a number of limitations contained in the USO claim calculations in their submission, namely:
  - This is the first such exercise by GO attempting to quantify the net USO cost
  - Modelling presents some limitations, including the need to approximate where data is not available/ only partly available.

# Analysis by component

## Geographical component

# The Geographical Component (1)
# GO's methodology

- The ***geographical component*** relates to the cost of providing telephony services across the entire country, so that all subscribers, irrespective of location, have access to a telephone at the same price anywhere in the country.
- GO uses Main Distribution Frames (MDF) areas as the basis to assess the geographical component and identify unprofitable areas. GO's network includes 22 MDF areas covering the whole of Malta and Gozo. The computation is based on active lines only and includes both business and residential customers.
  - The inclusion of active lines only in the geographical component calculation represents normal practice since inactive lines cannot be included as part of any potential compensations
- GO have based their claim on the total net margin of unprofitable MDFs, where the Net Margin is determined as follows:

| **Revenue and cost by MDF** | **€** |
|---|---|
| Line rental revenue (including line rental from both residential and business subscribers, share of bundle subscriptions) | |
| Traffic revenue (on net calls, international, fixed to mobile, off net, broadband, telecare, OTC, international incoming and other revenue) | |
| = Total revenue | |
| | |
| Less: | |
| Technical line cost (local loop cost + subscriber based costs) | |
| Other line cost (commercial and corporate costs) | |
| Traffic cost | |
| Broadband cost | |
| Other costs | |
| = Total cost | |
| | |
| **Net revenue / (cost) by MDF** | |

# The Geographical Component (2)
# GO's methodology

- In its USO claim GO submitted two options for the calculation of the geographical component: one based on the inclusion of on-net traffic, and one without on-net traffic. For each option, GO provided two scenarios:– one based on current tariffs and one on line rental post rebalancing as per table below.
- Under the current tariff scenario (with and without on net traffic) GO is claiming part of the access deficit as a geographical component. Given the conclusions reached in the reasoning phase (i.e. access deficit should not form part of the USO claim), the remaining analysis focuses only on the scenario with line rental post rebalancing, i.e. Option 1B and Option 2B.

| Loss-making MDFs | Option 1 - With on net traffic | | Option 2 - Without on-net traffic | |
|---|---|---|---|---|
| | Current tariff scenario Option 1A | Post Rebalancing Option 1B | Current tariffs scenario Option 2A | Post Rebalancing Option 2B |
| | € '000s | € '000s | € '000s | € '000s |
| MDF1 | -620 | -22 | -614 | -14 |
| MDF2 | -43 | - | - | - |
| MDF3 | -466 | - | -395 | - |
| Total | -1,129 | -22 | -1,009 | -14 |

- During the reasoning phase it was concluded that further information was required to determine whether the geographical component was to include "on-net" calls or not (Option 1B or Option 2B).
- The net cost of unprofitable MDFs should be based on all revenues and costs related to the service offering, including also on-net calls which are part of the USO service. However the USO should not be used to compensate for pricing / competition issues.
  - Based on information submitted by GO it was not possible to determine why "on net" calls were being provided at a loss, and whether this could be due to the impact of bundle offerings, particularly in certain locations. Bearing in mind that there is no price control on call tariffs, the losses from "on net" calls would not represent a USO cost unless it can be proven by GO that these are due to geographical issues rather than pricing issues / bundle offerings.
- In the absence of such a calculation, the assessment of the geographic component is based on a scenario without on-net traffic. The forthcoming calculation analysis is hence based only on Option 2B (rebalanced line rental without on-net traffic), where only one MDF remains loss making, amounting to a claim of €14,010.

# The Geographical Component (3)
# Key assumptions – revenues

- In order to estimate the net cost of the geographical component, based on rebalanced tariffs but excluding on-net traffic (Option 2B), a profit and loss approach by MDF was adopted. Revenue and cost assumptions are discussed next.
- In their September 2013 replies, GO explained the process of extracting data from the billing system as at June 2010 and matching it by MDF. The June cut-off point was chosen as a proxy for the entire year (instead of working out monthly details per subscriber). This estimation resulted in certain differences in the revenues and costs of broadband and line rental compared to the regulatory accounts and the audited financial statements. GO provided explanations for these differences.

| Revenue by MDF | Assumption |
|---|---|
| Line rental revenue - residential | • Number of residential lines x estimated rebalanced line rate of (instead of the current monthly line rental)<br>• The number of residential lines was extracted from GO's data warehouse IT database and includes all active residential lines as at June 2010, including those with bundle offers and Easyline and subsidised lines, but excluding lines with no telephone and no broadband revenues, and excluding payphone lines<br>• The rebalanced line rental was estimated by adding the monthly technical cost/ line and the monthly commercial & corporate cost/ line (described under the Cost assumptions below) |
| Line rental revenue - business | • Number of business lines x estimated rebalanced line rate (instead of the current monthly line rental)<br>• The number of business lines was extracted from GO's data warehouse IT database as at June 2010 and includes all active lines as at this date.<br>• The rebalanced line rental was estimated adding the monthly technical cost/ line and the monthly commercial & corporate cost/ line (described under the Cost assumptions below) |
| Call revenue - on-net | • Not included under Option 2B |
| Call revenue - international outgoing, fixed-to-mobile, off-net, broadband, Telecare, other ("OTC") | • All figures are hard-coded, and based on information provided by GO which has been extracted from the billing data and are based on actual revenues for 2010. |

# The Geographical Component (4)
# Key assumptions – revenues

| Revenue by MDF | Assumption |
|---|---|
| Call revenue - International Incoming | • International incoming traffic x average revenue of<br>• International incoming traffic has been based on total incoming traffic volume (hard-coded, and based on traffic statistics as per regulatory accounts) and has been apportioned by MDF on the basis of outgoing international traffic. GO does not have statistics on terminating international calls by MDF, and as a result international incoming revenue was split by MDF according to this basis.<br>• Average revenue per minute is based on total related revenues divided by related volumes (both hard-coded, and based on traffic statistics and revenue as per regulatory accounts) . |
| Other revenue | • Other revenue related to supplementary services and remaining activities (obtained from the regulatory accounts), allocated to MDFs on the basis of MDF traffic revenue as a percentage of total traffic revenue. |

- In order to avoid double counting, the other USO components which have been separately identified were excluded:
  - Payphones lines
  - Directory enquiry services
  - USO discounts (social tariffs) – in the case of social tariffs, lines eligible to social tariffs were treated as normal lines, and the discount portion considered separately under social tariffs (discussed as a separate component as from pg. 33 of this report)

# The Geographical Component (5)
# Key assumptions – costs

▸ The following table presents the cost assumptions

| Cost by MDF | Assumption |
|---|---|
| Technical Line Cost | • Number of active lines x operating cost and cost of capital/ line + line length x operating cost and cost of capital/ copper line length<br>• The operating cost and cost of capital per line relates to the LAN cost of line cards, FMUX equipment, other activities, corporate costs and the licence fee, and is divided by the total number of active lines. This data has been obtained from the regulatory accounts model<br>• The operating cost and cost of capital per copper line length relates to the cost of the copper only, and is divided by the total copper line length. This data has been obtained from the regulatory accounts model |
| Other Line Cost | • Number of residential lines x residential commercial & corporate cost/ line<br>• Number of business lines x business commercial & corporate cost/ line<br>• The residential commercial & corporate costs relate to Talk 200, Free Nights and Weekends scheme, Talk Anytime, and general residential line rental. This data has been obtained from the regulatory accounts model<br>• The business commercial & corporate costs relate to Talk 500 and the Access Business package<br>• These costs have been derived from the regulatory accounts, from where GO obtained the retail cost per regulated retail service. These retail costs were split between commercial and corporate costs, costs of good sold and other. This data is extracted form the regulatory accounts model and ties in with the Retail Business sheet. |
| Traffic Costs | • Traffic volumes (outgoing international, fixed-to-mobile, off-net, international incoming) x unitary cost/minute<br>• Traffic volumes were extracted from billing data (and therefore include all traffic including all free minutes in bundles)<br>• Unitary costs/ minute have been based on the applicable termination rates and the commercial cost/ minute<br>• The commercial cost has been derived from the regulatory accounts model |
| Termination rates included in traffic costs | • Termination rates have been based on the 2010 rates applicable to all mobile operators having been designated with an SMP status in the provision of mobile termination services market, as per the MCA's Decisions, including:<br>  • Fixed-line termination rate: average of €0.007163/ minute as per MCA/10/48/D, Fixed Interconnection Pricing Review – 2010, pg. 6; and symmetric rate of €0.0866/ minute , as per MCA's 2009 Decision (Wholesale mobile termination rates in accordance with the MCA Decision Notice on Wholesale Call termination on individual mobile networks)<br>  • Mobile termination rate: €0.0617/ minute as per MCA/10/46/D, Review of Wholesale Mobile Termination Rates – 2010, pg. 7 |
| Broadband Cost | • Broadband revenue generated by each MDF (which is hard-coded) x (1 – ADSL net margin)<br>• The ADSL margin is estimated on the basis of information included in the regulatory accounts, and taking into account (a) revenues, (b) operating costs, and (c) the cost of capital employed at 12.56% (MCA Decision on WACC for regulatory accounting periods ending on or after 31 Dec 2010, ECS WACC Review 2011, p. 6) on ADSL Capital Employed, a breakdown of which has been provided by GO in its Sept 2013 replies. |
| Other costs | • Other costs include operating costs of supplementary services and remaining retail activities, which costs are not traffic-based and not related to line rental costs. Other operating costs are allocated to MDFs on the basis of total MDF traffic revenue as a percentage of total revenue (same basis for allocation of supplementary revenues) |

# The Geographical Component (6)
# Review work and Conclusion

**Review work**

- As part of our review work, we have considered the arithmetical accuracy and allocation calculations carried out, and report that no exceptions were noted.
- Due to the use of different sources to estimate the revenue and costs by MDF, we have requested GO to provide a reconciliation of revenues and costs used in the USO claim with the regulatory accounts.
  - GO provided a revenue reconciliation on 6 September 2013, explaining the reasons for the differences. To this effect no adjustment claim was received by the MCA to take into account these differences.

**Conclusion**

- The Geographical Component claim should be based on Option 2B, which results in a net cost of €14,010 related to one MDF only. This Option is based on rebalanced tariffs for line rental and excludes on-net traffic.
- Going forward the geographical component calculation should technically include on-net calls provided that these are computed on a "rebalanced" tariff approach, and/ or alternatively more information is submitted on bundling so that it is possible to exclude the excess of on-net calls related to bundles which are not priced in the bundle, but which still bear a cost (e.g. in terms of interconnection), from the USO geographical component claim.

# Analysis by component
## Public payphones

# Public payphones (1)
# GO's methodology

- The ***public payphones*** claim relates to the net cost of serving the territory with public payphones.
- The claim is based on a similar approach to the geographical component, with GO presenting a claim for the net cost of unprofitable payphones on an individual payphone basis. In its submission, GO provides a breakdown of all payphones in all Malta and Gozo localities.
- The net margin per payphone is determined as follows:

| **Revenue and cost by individual payphone** | | **€** |
|---|---|---|
| Revenue from calls | | |
| | | |
| Less: | | |
| Direct operating costs | Cost of sales (cards) | |
| | Commissions paid to distributors | |
| | Sub-contracting costs (related to line fault repairs) | |
| | Electricity | |
| | Other operating costs (rent, repairs & maintenance, insurance, electricity) | |
| Depreciation | | |
| | | |
| **Net revenue / (cost) by payphone** | | |

# Public payphones (2)
# Existing vs. Optimal number

- During the initial reasoning phase it was concluded that the net cost of payphones should form part of the USO claim. However, the issue remains one related to the quantum of payphones on which the claim should be based and whether the claim should be based on the existing number of payphones or the optimal number / minimum requirement as set out in the 2010 USO Decision Notice issued by the MCA. Following a request by the MCA, GO presented an estimation of the claim based on existing and optimal number of payphones as per table below:

| | Existing no of payphones | Optimal no of payphones (based on 2010 DN) |
|---|---|---|
| Total number of payphones | 939 | 184 |
| No of unprofitable payphones | 721 | 105 |
| Net cost of unprofitable payphones | €281,157 | €33,629 |

- When discussing the above claim, the following was considered:
  - the Decision Notice issued in April 2010. Prior to this there was no formal mechanism in place to remove payphones, and this could bear on the number of payphones to be included.
  - In 2009, GO requested the MCA for the removal of a number of payphones which the MCA had granted (the removal of a few of these payphones were granted subject to certain conditions being met).
  - In 2010, GO requested for the removal of 2 public payphones which the MCA had granted.
  - GO's plans, if any, for the removal of payphones
  - According to information provided by GO, 68 payphones are protected by MEPA (cannot be physically removed but there could still be a change of use)
- The MCA is of the opinion that the payphones claim should be based on the optimal number of payphones, and as a result the forthcoming analysis is based on the optimal number of payphones only.

# Public payphones (3)
# Key assumptions

- The following table summarises the key assumptions used to arrive at the payphone net cost.

| Revenue and costs | Assumption |
|---|---|
| Revenue | • Billing data for on-net calls, outgoing international , mobile calls, and off-net calls (all figures are hard- coded) |
| Technical Line costs (same as per geographical component) | • Operating cost and capital cost/ line + Line length x operating cost and cost of capital/ copper line length<br>• The operating cost and cost of capital per line relates to the LAN cost of line cards, FMUX equipment, other activities, corporate costs and the licence fee, and is divided by the total number of active lines. This data has been obtained from the regulatory accounts model<br>• The operating cost and cost of capital per copper line length relates to the cost of the copper only, and is divided by the total copper line length. This data has been obtained from the regulatory accounts model |
| Traffic costs (same as per geographical component) | • Traffic volumes (on-net, outgoing international, fixed-to-mobile, and off-net) x unitary cost/minute<br>• Traffic volumes were extracted from billing data<br>• Unitary costs/ minute have been based on the applicable termination rates and the commercial cost/ minute<br>• The commercial cost has been derived from the regulatory accounts model |
| Direct OPEX | • Equal allocation of operating costs (derived from actual invoices), including:<br>  • Cost of sales - cards<br>  • Commissions paid to distributors of payphone cards (both easyline and telecards)<br>  • Share of corporate<br>  • Sub Contracting Costs<br>  • Electricity<br>  • Hire of Premises<br>  • R&M - Cardphones<br>  • Various Insurance Covers<br>  • Metering cost |
| Depreciation and Amortisation | • Equal allocation of depreciation obtained from the regulatory accounts model |
| Cost of Capital | • Regulatory cost of capital (derived from plant register), including batteries, booths, card reader kit, coin boxes, payphones (both card and coin), and software<br>• Cost of capital of 12.56% based on MCA Decision on WACC for regulatory accounting periods ending on or after 31 Dec 2010. ECS WACC Review 2011, p. 6) |

# Public payphones (4)
# Review work

- From our review work we have identified the following allocation issues:
  - Cost of sales related to cards have been apportioned equally across all 939 payphones, even though in its replies GO refers to an apportionment on the basis of revenue from actual payphones.
  - Commissions paid to distributors of cards (both Easyline and telecards) have been apportioned equally across all 939 payphones even though in its replies, GO refers to an apportionment on the basis of revenue from payphones.
  - Rent of premises is allocated across all payphones, rather than directly to the specific payphones for which it is being paid.
  - Capex - In order to arrive at the cost of capital, GO provides a list of capital expenditure. One of these is titled “n/a”, and as per replies received by GO, it refers to various fixed asset items that are fully depreciated. GO’s USO model shows a negative Net Book Value, which results in a minimal increase in the cost of capital and a resulting difference in the net margin
- As part of our work, we have prepared an alternative scenario taking into account the following adjustments
  - Cost of sales of cards and Commissions paid to distributors of cards, apportioned on the basis of revenue
  - Removal of the negative Net Book Value from the capital expenditure workings. This resulted in a marginal increase in the cost of capital
  - Rent allocated directly by payphone. According to a GO clarification, the MIA rent is not allocated directly to the MIA payphones but is apportioned on all payphones. We have asked GO for a list of rental values by location, and according to GO these are all attributable to the MIA payphones.

# Public payphones (5)
# Conclusion

- The adjusted figures for the payphone claim (based on the optimal number of payphones), is shown in the table below.

| | Optimal number of payphones | |
|---|---|---|
| | GO's claim | Adjusted Scenario |
| Number of payphones | 184 | 184 |
| Unprofitable payphones | 105 | 105 |
| USO claim based on unprofitable payphones | -€33,629 | -€26,276 |

- The MCA is of the opinion that the payphones claim should be based on the optimal number of payphones, resulting in a claim of €26,276.

# Analysis by component
## Social tariffs

# Social tariffs (1)
# GO’s methodology

- The ***social tariffs*** claim relates to the cost of providing service to certain categories of people (e.g. low income)
- The cost of social tariffs is computed as the difference between the discounted rate (i.e. free of charge) and the normal retail rate of:
  - Current line rental fee
  - Rebalanced line fee
  - Standard Telecare fee
- In view of our conclusions in the reasoning phase that access deficit should not form part of the USO claim, then it follows that the social tariff computation should be based on current tariffs, that is, Scenario 1 of GO’s calculation. **The forthcoming calculation analysis is based only on Scenario 1.**

| Pack | Rental Profile | Current | |
|---|---|---|---|
| | | Reduced Tariff Options for Users | Specific Measures for Disabled Users |
| | | € | € |
| DUO | Free Rent and Charged Telecare | 7 | n/a |
| HOME | Free Rent and Charged Telecare | 329 | n/a |
| | Free Rent and Free Telecare | 62 | 62 |
| No pack | Charged Rent and Charged Telecare | n/a | n/a |
| | Charged Rent and Free Telecare | n/a | 1,018 |
| | Charged Rent No Telecare | n/a | n/a |
| | Free Rent and Charged Telecare | 647 | n/a |
| | Free Rent and Free Telecare | 1,664 | 1,664 |
| | Free Rent No Telecare | 2,696 | n/a |
| | Total | 5,405 | 2,744 |
| | Applicable line rental (€/ month) | 5.07 | 2.13 |
| | Total annual cost | 328,516 | 70,137 |

# Social tariffs (2)
# Review work

- One of the conclusions of the Reasoning phase was to discuss the approach and obtain a sample of the beneficiaries. The number of social tariff beneficiaries are published on the Ministry for Health's website and further confirmation was obtained from the responsible Ministry. Some differences were noted between the number of beneficiaries as per GO and those as per Ministry. Adjustments were made to GO's calculation to take into account these differences.
- Apart from the above adjustments and considerations, we have considered the arithmetical accuracy and allocation calculations, and note no further exceptions.
- The table below includes the amended computation of the social tariffs:

| | Reduced Tariff Options for Users | Specific Measures for Disabled Users | Total |
|---|---|---|---|
| | € | € | € |
| Total | 5,405 | 2,744 | |
| Less: Error in Telecare beneficiaries | 398 | 62 | |
| Total (amended) | 5,007 | 2,682 | |
| Applicable line rental (€/ month) | 5.07 | 2.13 | |
| Total annual cost (adjusted) | 304,325 | 68,552 | 372,877 |
| Total annual cost (as per GO's claim) | 328,516 | 70,137 | 398,653 |

- The social tariff claim should be based on Scenario 1 (current tariffs), which results in a net cost (as adjusted for the number of subscribers as per Ministry of Health website) of €372,877.

# Analysis by component

## Directory enquiry services (DES)

# Directory enquiry services (1)
# GO's methodology

- The cost of the provision of the ***directory enquiry services*** was obtained from the management cost accounting system (costs used in the regulatory accounts and found in the Retail Business sheet), and includes:
  - Call revenues from the 1182 enquiry service
  - Call costs valued at transfer cost
  - Operating cost of the call centre
  - Share of corporate costs
  - Cost of capital with 12.56% WACC

| | Business | Residential | Total | Comment |
|---|---|---|---|---|
| | € | € | € | |
| Call charges | | | | |
| Less: | | | | |
| Operating costs specific to Retail | | | | |
| Payphone transfer charge | | | | |
| Transfer charges from Core Network | | | | |
| Less: Cost of Capital | | | | |
| Tangible fixed assets | | | | |
| Intangible fixed assets | | | | |
| Stocks | | | | |
| Debtors | | | | |
| Cash at bank and in hand | | | | |
| Creditors | | | | |
| Net assets | | | | |
| Cost of capital | | | 12.56% | MCA Decision on WACC for regulatory accounting periods ending on or after 31 Dec 2010. ECS WACC Review 2011, p. 6 |
| Less: Cost of capital | | | | |
| | | | | |
| Total cost | | | -79,646 | |

# Directory enquiry services (2)
# Review work and Conclusion

- We understand that other operators are also currently offering directory enquiry services .
- We understand that there is currently an arrangement between operators on sharing of customer details for directory enquiry purposes.
  - We have asked GO to provide us with further information to understand how this arrangement impacts the calculations.
- According to GO, there is an arrangement between the operators to share their respective directory data in order to provide telephone numbers of other operators. This system is electronic and for every dip into the directory data of a respective operator there is a charge of €0.07. This arrangement was made with the direct involvement of the MCA in discussions held at the time among the operators.
- It is unclear how this charge of €0.07 is being included in GO's USO claim on directory enquiry services, and whether charges receivable from other operators are offsetting charges payable from other operators. According to GO, these DES dips are not reflected in the retail costs in the model since these are captured with out-payments in GO's wholesale core section.
- As part of our review work, we have considered the arithmetical accuracy and allocation calculations carried out, and report that no exceptions were noted.

**Conclusion**

- The directory enquiry services claim should be equal to the claimed amount of €79,646.

# Analysis by component

## Intangible benefits

# Intangible benefits (1)
# GO's methodology

The net cost is calculated by deducting the revenues of intangible benefits that the operator derived from the provision of the USO, from the costs of the USO components.

GO provided estimates for the following two intangible benefits:

- ***Ubiquity***: benefit associated with the comparatively lower cost of the USO operator compared to the competitors in extending network to new customers

- ***Brand enhancement***: the benefit associated with the enhancement of the USP brand through the fulfillment of the USO. This affects the customer perception (of its own and other operators' brands), thereby impacting on the provider's overall profitability.

Other intangible benefits which were not considered by GO include:

- ***Life cycle***: evaluation in terms of the evolution of the average telephone bill, and the increase of the telephone bill through the evolution of the family structure

- ***Marketing/ access to customers' database***: benefit associated with the savings in acquisition costs and operational costs of a customer's database

# Intangible benefits (2) GO's methodology

**Ubiquity**

- GO have based their ubiquity calculation on the below assumptions/ methodology:

| | Item | Value | Comment |
|---|---|---|---|
| a | Moves/year | | |
| b | of which residential | | |
| c | of which in the same zone | | |
| d=a*b*c | Residential moves outside zone | | |
| f | # of zones | | |
| g | # of unprofitable zones | 1 | Under Option 2B, as per the Geographical Component conclusion |
| h=f/d | Res moves outside zone | | |
| i=(f-g)*h | Moves from unprofitable zones to profitable zones | | |
| j | Competition market share in acquisition | | |
| k=(1-j)*i | Loyal customers | | |
| l | Net annual margin/customer (€) | | |
| m=k*l | Ubiquity benefit (€) | 7,190 | Option 2B |

- According to GO, this figure is an upper bound as it is likely that loyalty is attributable to marketing efforts rather than because of the USP position.
- GO also pointed out that it is probably the smallest incumbent network in Europe and is not integrated with other telecom companies. In view of this, GO cannot benefit from any economics of scale on its purchases (so cannot compute an estimate on the basis of the benefit from economies of scale on CAPEX purchases)

# Intangible benefits (3)
# GO’s methodology

**Brand enhancement**

- GO have based their Brand Enhancement calculation on a percentage of advertising on different media such as TV, internet, mobile and fixed telephony:

| Campaign | € |
|---|---|
| Total Related Advertising | |
| | |
| % for brand image | 20% |
| Brand image benefit | 190,695 |

- GO didn’t undertake any survey or economic study but utilised Ofcom/ BT’s approach of allocating 20% of relate marketing expenses to the brand image benefit
- Brand enhancement has been based in terms of advertising expenditure, with the benefit valued at 20% of this expenditure

# Intangible benefits (4)
# Review work

- In order to understand the reasoning behind the brand enhancement calculation, we asked GO to justify the choice of the 20% factor included in the calculation.
- According to GO, there is no significant awareness that GO is a USP since Melita provides similar offers to GO and has a nation-wide network coverage.
- To assess this intangible benefit, a market study would have to be carried out to identify the public's knowledge and perception on the issue of universal service in Malta. Where this was carried out in other jurisdictions, it was typically done by the NRA. In view of the costs involved in such an exercise, GO believes that a benchmark with international experience is more than adequate.

- We also asked GO to justify why other intangible benefits were not quantified.
- According to GO, the lifecycle benefit was not assessed because:
  - GO has no figures or studies to estimate a forecast of ARPU according to household consumption
  - The use of telephony by children increases as they grow up, but it is likely that these children will adopt the mobile phone rather than increase their use of the fixed phone in the next 5 years
  - The argument can be reversed: what happens when children leave the household?
  - Benchmarking shows that this benefit is not evaluated in USO funding claim processes, except for Belgium in 2003.
- The Marketing benefit was not assessed because, due to the nature of Maltese payphones (material difficulty to expose any posters on the booths, partly because most are not commonly used), GO does not consider this intangible benefit relevant.

- As part of our review work, we have considered the arithmetical accuracy and allocation calculations carried out, and report that no exceptions were noted.

# Intangible benefits (5)
# Review work

**Ubiquity**

- GO have based their ubiquity calculation on residential moves per year only.
- According to GO's clarifications, the USO is not directed to cater for businesses but to residential customers. However, businesses were included in the geographical component calculation.
- As a result, GO's ubiquity calculations have been adjusted to include businesses, as shown below:

| | Item | Value | Comment |
|---|---|---|---|
| a | Moves/year | | |
| b | of which residential | 100% | Adjustment |
| c | of which in the same zone | | |
| d=a*b*c | Residential moves outside zone | | |
| f | # of zones | | |
| g | # of unprofitable zones | 1 | Under Option 2B, as per the Geographical Component conclusion |
| h=f/d | Res moves outside zone | | |
| i=(f-g)*h | Moves from unprofitable zones to profitable zones | | |
| j | Competition market share in acquisition | | |
| k=(1-j)*i | Loyal customers | | |
| l | Net annual margin/customer (€) | | |
| m=k*l | Ubiquity benefit (€) | 10,731 | Option 2B |

- The above adjusted figure of €10,731 (previously €7,190) again refers to the value under Option 2B (Geographical Component) only (i.e. based on rebalanced tariffs and excluding on-net calls), adjusted to include businesses.

# Intangible benefits (6)
# Conclusion

- The value of the intangible benefits to be deducted from the cost of the other components should be equal to:
  - Ubiquity: €10,731 based on Option 2B and adjusted for the inclusion of businesses
  - Brand enhancement: €190,695
- Calculating intangible benefits is difficult due to their very nature, but the approaches applied by GO appear reasonable and in line with international precedent.

# Summary of conclusions

# Calculation Phase: summary of conclusions

Based on the considerations contained in this report, the following table summarises the conclusions of the Calculation phase.

| Component | € | Summary of conclusion |
|---|---|---|
| **Geographical component** | -14,010 | Based on rebalanced tariff, and excluding on net calls |
| **Payphones** | -26,276 | Based on optimal number of payphones |
| **Social tariffs** | -372,877 | Based on current tariffs (adjusted for discrepancy between beneficiaries on Ministry for Health website and GO USO model) |
| **Directory enquiry services** | -79,646 | As per GO USO claim |
| **Ubiquity** | +10,731 | Based on Option 2B adjusted for the inclusion of businesses |
| **Brand enhancement** | +190,695 | As per GO USO claim |
| **Total** | -291,382 | |

- The resulting USO net cost amounts to €291,382.

# Appendix: Source of information / data

**Reasoning Phase**

- Covering letter related to USO funding application, dated 20 Feb 2012 and received by EY on 17 Dec 2012
- Evaluation of Universal Service obligations costs in Malta (Methodology and Results), prepared by Marpij Associes (GO's external consultants) for GO, dated 11 January 2012 and received by EY on 17 Dec 2012
- Cost Evaluation of Universal Service Obligation for GO (Cost Model), prepared by Marpij Associes for GO, dated Feb 2012 and received by EY on 17 Dec 2012
- Meeting held on 20 Feb 2013 between GO, Marpji, MCA and EY wherein Marpji presented an overview of the claim and the methodology used in estimating the claim, as well as preliminary feedback to the initial list of information requirements sent by the MCA/EY
- Meeting held on 28 June 2013 between GO, MCA and EY wherein the conclusions related to the Reasoning Phase were presented
- GO's replies to the MCA's initial Information request list, dated 27 Feb 2013 and 18 Mar 2013
- Benchmark of Universal Service Obligations in Europe – Scope, methodologies and lessons, prepared by Marpij Associes for GO, dated 4 Nov 2011 and received on 1 Mar 2013

**Calculation Accuracy Phase**

- Meeting held on 26 Aug 2013 between GO, MCA and EY wherein GO provided preliminary feedback to the additional list of information requirements sent by the MCA/EY.
- GO's replies to MCA's information request list, received on 9 Sept 2013, 9 Oct 2013 and 19 Dec 2013
- Confirmation by Ministry for the Family and Social Solidarity of the terms for subsidised line rentals under social tariffs, received by the MCA and sent to EY on 18 Feb 2014
- Sample of traffic volumes provided by GO, and received by EY on 22 Oct 2013